would not be changed by this proposal. In lieu of the other categories and subindexes, however, all services within the trunking basket should be subject to a "cost consistency" test. The LEC should be required to report the unit cost associated with each rate element.[15] The ratio of price to cost for any rate element within the basket (or within any of the three zone subindexes, for those carriers that have adopted zone pricing) would not be permitted to vary from the basket or zone average ratio by more than 10 percent.

The cost consistency test would *not* be a return to cost-plus pricing or rate-of-return regulation. No allocation of overhead or common costs is proposed; only the incremental costs directly attributable to each rate element would be considered. Prices would, of course, exceed these direct costs because of the need to recover overheads and common costs, but the Commission would not regulate the mark-up above cost as long as the mark-up is applied consistently to all rate elements and as long as the overall price index does not exceed the Price Cap Index. The ability to vary the price to cost ratio by up to 10 percent for individual rate elements would allow the LECs to adjust individual price elements in response to perceived competition, and also would make the plan easier to administer than a requirement of absolute consistency. Further, since the cost

[15] For the reasons discussed under Baseline Issue 11, below, the unit cost should be determined using the Total Service-Long Run Incremental Cost methodology. It is particularly important that costs for all services be developed using a consistent set of assumptions regarding such variable factors as equipment life, capacity utilization, and discount rates (among others). Price-to-cost comparisons cannot be meaningful unless all cost data are prepared on a consistent and auditable basis.

consistency rule would only apply to services within the trunking basket, it would not change the overall level of prices in that basket or in any other basket.

This approach would permit the LECs to offer volume, capacity, and term discounts as long as they can demonstrate that the discounts are cost-justified. For example, if Service A costs 25 percent less to provide per unit of capacity than Service B, then Service A could be priced 25 percent lower as well. In addition, LECs would be free to change historical price relationships when they can demonstrate that the underlying costs have changed. If the cost of Service A declines by 10 percent over the course of a year while the cost of Service B remains unchanged, then the prices should change in similar proportion.[16]

The chief objection likely to be raised against this proposal by the LECs is that the requirement to compute the incremental cost for each rate element would be unduly burdensome. Although this proposal would indeed impose some new burdens on the LECs, these burdens are not unduly complex or unreasonable under the circumstances. First, it is safe to assume that the LECs already compile cost data on their services for their internal purposes, and in some instances are required to do so by state commissions with respect to their intrastate services, so that this information could be used as the basis for price regulation of interstate services without substantial additional burden. Second, whatever additional burden is imposed is justified by the Commission's statutory

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[16] Under the existing price cap rules, if Service A and Service B are in different categories, the LEC cannot reduce Service A's price by 10 percent in one year even if this reduction is cost-justified. This restriction in the existing rules creates a disincentive for the deployment of newer and more efficient technologies, and is therefore inconsistent with the Commission's objective of stimulating economic growth.

obligation to prevent unreasonable discrimination, and by the fact that the dangers of such discrimination are particularly acute during the period that LEC markets are in transition from monopoly to competition.

If the Commission declines to adopt the cost consistency requirement, then MFS is concerned that LEC abuses and discriminatory pricing will continue unabated, regardless of what refinements may be made to the baskets and pricing bands. As a distinctly inferior alternative, however, MFS would urge adoption of rate-element banding in the trunking basket (that is, no individual rate element could be increased or decreased by more than 5 percent annually relative to the PCI, except for those elements with special pricing rules such as the interconnection charge). Although this approach has disadvantages, it would at least prohibit the more egregious LEC abuses identified above.[17] LECs could still file within-cap, above-band (or below-band) tariff revisions

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[17] As noted earlier, the only reason given by the Commission for rejecting rate element banding in the *LEC Price Cap Order* was administrative burdens. The Commission reasoned as follows:

> There are thousands of rate elements, particularly in special access, that would need to be separately banded if we adopted rate element banding. Each time a carrier filed a tariff transmittal, the rate elements affected by the transmittal would have to be accompanied by index information necessary to ensure compliance with the bands. In the case of the annual filing, this would have to be done for approximately 11,000 rate elements.

Id., para. 222. Experience since that time has shown that this concern was greatly overstated. The price cap LECs already have to file demand and rate information for every rate element, as part of their Tariff Review Plans, in order to compute their index levels under the existing rules. Requiring computation of the percentage change for each rate element would only require the addition of one extra column to the TRP spreadsheets. The TRPs are generated by computer software, so addition of the extra column would be a minor revision to the spreadsheet files, after which the necessary computations would be performed automatically by the software. Now that the Common Carrier Bureau and the LECs have several years of experience with the TRP process, a change of this nature would be quite easy to implement.

with cost support if they desired to make rate adjustments in excess of 5 percent annually, as under existing rules.

Baseline Issue 8a: Whether the LEC price cap new services requirements impose unnecessary regulatory impediments to the development and introduction of new services, with specific identification of what those impediments are and an assessment of their magnitude.

In soliciting comment on possible changes to the price cap rules' treatment of new services, the Commission noted that the rules seek to reconcile two goals that may be in conflict: 1) providing LECs with incentives to introduce new and innovative services, and 2) ensuring that the rates for new services are set at reasonable and nondiscriminatory levels. On the one hand, the Commission states that there may be "some merit" in LEC arguments that the pre-effective tariff review process for new services under price caps results in lengthy delay and imposes burdensome cost support requirements.[18] On the other hand, the Commission recognizes that LECs have an incentive to price services subject to competition unreasonably low, while pricing monopoly services—and bottleneck services that competitors must purchase—unreasonably high.[19]

As with any regulatory initiative, responsible public policy requires a balancing of potentially competing interests to effect an outcome that will best serve the public interest. As discussed below, consistent experience throughout the first three years of price cap regulation clearly demonstrates that LECs have not been inhibited from

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[18] *Notice*, para. 79.

[19] *Id.*, para. 80.

introducing new services, and that potential abuse of LEC pricing flexibility under price caps has yet to be addressed effectively.

LEC tariff filings over the past three years clearly belie the arguments that LECs lack incentive to deploy new technology or initiate new services. In the 1994 annual access filings, the Bell Operating Companies and the GTE Operating Companies identified 89 new services that had been introduced within the last 18 months, and that were being incorporated into price caps for the first time.[20] During the first three years of price caps, the largest LECs have introduced new state-of-the-art services that are designed expressly to compete against CAPs: BellSouth and Southwestern Bell introduced, and U S West expanded, fiber-ring network services that mirror the networks deployed by MFS and other CAPs;[21] NYNEX has introduced guaranteed all-fiber transmission[22] and a "Crisis Management" service[23] to provide increased circuit protection; Bell Atlantic, NYNEX and Pacific Bell all introduced alternate serving wire

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[20] For example, both NYNEX and U S West reported 16 new services incorporated into their price cap computations this year. NYNEX Tariff F.C.C. No. 1, Transmittal No. 288, Appendix F; U S West Tariff F.C.C. No. 1, Transmittal No. 465, Section 1, Workpaper 11.

[21] BellSouth's SMARTRing service [BellSouth, Tariff F.C.C. No. 4, Transmittal No. 402 (issued June 13, 1991)] and Southwestern Bell's STN service [Southwestern Bell, Tariff F.C.C. No. 68, Transmittal No. 2067 (issued January 30, 1991)] were introduced in mid- and late 1991; U S West's Self-Healing Alternate Route Protection Service and Self-Healing Network Service [U S West, Tariff F.C.C. No. 1, Transmittal Nos. 80 & 81 (issues June 4, 1990)] were introduced in late 1990, and have been expanded subsequently.

[22] NYNEX's fiber-based channel termination rate elements were introduced in mid-1991. NYNEX, Tariff F.C.C. No. 1, Transmittal No. 3 (issued January 29, 1991).

[23] NYNEX, Tariff F.C.C. No. 1, Transmittal No. 181 (issued April 15, 1993).

center diversity services;[24] and Southwestern Bell introduced its "DOVLink" data-over-voice service.[25] In addition, all of the major LECs have been aggressive in deploying fiber optic cable[26] and SS7 technology[27] throughout their networks. This list is in no way exhaustive—LECs have introduced a plethora of new service offerings during the first three years of price cap regulation. MFS is not aware of *any* genuinely new services (as opposed to new pricing options for existing services) that have been rejected or withdrawn as a result of this Commission's regulatory review or tariff filing procedures.

Moreover, the Tier 1 LECs have in fact been very aggressive in using the "new services" rules to reprice existing services to achieve strategic goals. The most recent

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[24] New York Telephone Company, Tariff F.C.C. No. 41, Transmittal No. 1104 (issued December 10, 1990); Bell Atlantic, Tariff F.C.C. No. 1, Transmittal No. 509 (issued May 8, 1992); Pacific Bell, Tariff F.C.C. No. 128, Transmittal No. 1563 (issued December 31, 1991).

[25] Southwestern Bell, Tariff F.C.C. No. 73, Transmittal No. 2211 (issued July 17, 1992).

[26] Jonathan M. Kraushaar, *Fiber Deployment Update*, 12-13 (Federal Communications Commission, Industry Analysis Division - Common Carrier Bureau, 1992).

[27] M. J. Richter, *SS7 Migration: Local Carriers Are Near Destination, The Ongoing Trek Toward Intelligent Networking Technologies Has Led LECs Close To Full SS7 Deployment*, Communications Week, January 24, 1994, at 4A; M. J. Richter, *What Carriers Want From Vendors*, Communications Week, January 24, 1994, at 8A; *ISDN Can Be In Place By 1995, RHCS Says In Reports To FCC*, Telephone Week, July 26, 1993, v. 10, no. 30; *Phone Companies Increase Plans For National ISDN Deployment*, ISDN News, April 21, 1993, v. 6, no. 8; *SNET's Connecticut 2000 Approved To Modernize Telecom Network*, Telephone News, February 8, 1993, v.14, no. 3; Daniel Briere, *RBHC Puts SS7, AIN Investment To Use*, Network World, January 11, 1993, at 89; *AIN's Year-End Wrapup And A Look Ahead*, AIN Report, December 23, 1992, v. 2, no. 25; *Untitled Article*, AIN Report, December 23, 1992, v. 5, no. 26; Karen Archer Perry, *The Race To Deploy SS7*, Telephony, July 20, 1992, at 25; *AIN RBOC Update*, AIN Report, July 8, 1992, v. 2, no. 13.

example is Bell Atlantic's Facilities Management Service ("FMS").[28] In introducing the service, Bell Atlantic established an unprecedented pricing structure for high capacity offerings to customers taking service at the DS3 level or greater. By so restructuring the service, Bell Atlantic has been able to provide exceptional discounts to FMS customers for service that is functionally identical to tariffed Special Access service. For example, a customer taking the FMS equivalent of one DS3 and six DS1 Special Access circuits would incur a charge 20% less than the tariffed rate for equivalent Special Access service.[29] Last year, NYNEX effected a similarly dramatic service restructuring when it introduced its Enterprise Service pricing structure for services ranging from low capacity DDS to DS3.[30] Other examples abound: GTE introduced a new service providing capacity packages of 12 DS3 circuits;[31] Bell Atlantic extended its DS3 volume discount rate structure to DDS and DS1 services;[32] Southwestern Bell introduced its "Network Optimization Plan," which effected broad waivers of nonrecurring charges for customers that reconfigure their networks;[33] and U S West

[28] Bell Atlantic, Tariff F.C.C. No. 1, Transmittal No. 586 (issued July 20, 1993).

[29] Assuming the customer takes service with electrical interface for a five-year term commitment, the FMS customer would incur a monthly charge of $2,309.28, while the Special Access customer would incur a charge of $2,890.00.

[30] NYNEX, Tariff F.C.C. No. 1, Transmittal No. 127 (issued October 22, 1992); Transmittal No. 177 (issued April 8, 1993); Transmittal No. 180 (issued April 13, 1993).

[31] GTOC, Tariff F.C.C. No. 1, Transmittal No. 753 (issued November 12, 1992).

[32] Bell Atlantic, Tariff F.C.C. No. 1, Transmittal No. 506 (issued April 2, 1992).

[33] Southwestern Bell, Tariff F.C.C. No. 73, Transmittal No. 2265 (issued March 9, 1993).

introduced limited promotional offerings.[34] All of these new service offerings simply repriced existing services or waived tariffed nonrecurring charges in order to provide substantial rate reductions to selected customers.

Baseline Issue 8b: Whether, and how, we should modify the LEC price cap new services procedures and cost support rules to ensure that these rules advance our goals of encouraging innovation and setting reasonable rates.

The examples cited in the preceding section demonstrate that price caps have not inhibited LECs from introducing a wide range of new technologies and revised rate structures under price caps. These examples also show that LECs have been able to use the price cap rules to target services to narrowly-defined categories of customers (or, in certain instances, perhaps a single large customer), and to obtain a level of pricing flexibility that enables them to lower rates for competitive services virtually to any level without restriction. Indeed, to the best of MFS' knowledge, since the introduction of price cap regulation, the Commission has never rejected any LEC rate reduction of any magnitude on cost grounds.

Based on this experience, the likelihood that LECs will use the pricing flexibility available under the "new services" rules to establish discriminatory or otherwise unreasonable rates far outweighs any hypothetical (and unproven) disincentive to the introduction of new services. This experience also shows that the price cap rules must be revised to provide additional protection against such pricing abuses.

[34] U S West, Tariff F.C.C. No. 1, Transmittal No. 196 (issued September 30, 1991).

As an initial matter, the Commission's definition of "new services" is overly broad. The price cap rules governing the filing of new services fail to distinguish between "truly new" services that introduce a new and substantially different technology, or provide a functionality that was not previously available, and the mere repricing of existing services for strategic purposes. The two groups of new services raise different regulatory concerns. For example, truly new services raise a potential concern that competitors may be denied nondiscriminatory access to the underlying network functions required if they are to compete against the new services. The deployment of SS7 technology and information databases are examples of these services.

Restructuring rates for existing services raises a different set of regulatory concerns. For typical LEC-initiated filings, the LEC is unlikely to overprice a new service option, but may seek to establish noncompensatory rates, or may seek to offer the new service in a discriminatory fashion in order to target selected customers in selected markets. For services that are required by Commission mandate, such as expanded interconnection, LECs may have an incentive to establish grossly excessive rates to defeat the Commission's policy objectives. In either case—whether the rates are set at unreasonably high or low levels—the LECs may employ this pricing flexibility to anticompetitive effect.

The Commission may address these differing regulatory concerns by effecting three changes to the price cap rules. First, new services should be incorporated into price caps immediately upon becoming effective. The initial demand quantities for the new services should be incorporated into the LECs' pricing index calculations premised on projected demand during the first 12 months of the service. The LECs should then be required to file quarterly reports showing the actual demand for the service, and should adjust the rates accordingly. By incorporating the services immediately into price caps, this step would reduce the potential for unreasonable discrimination. By tying new service rates to actual, measured demand over the first year of service, this step would help to ensure that the rates are reasonable.

Second, all services should be classified based on whether they share underlying network functions and facilities with existing services. For example, the transport component of SS7 service uses the same interoffice facilities as special and switched access transport, and should be placed in the same pricing category, even though the end products of the services are not directly comparable. This will further protect against discrimination against similarly-situated users of LEC network facilities.[35]

Third, as discussed above, new services that will be placed in the trunking basket should be subject to a cost consistency test. As MFS explains in response to Baseline Issue 2, the cost consistency requirement is the only means of preventing the discriminatory use of disparate costing methodologies among customers of functionally similar services, and of ensuring reasonable rates under the price cap system. The cost

[35] This focus on identical functionalities also militates against the proposed alternative of establishing different forms of regulatory oversight for different services, depending on their classification as competitive, monopoly or interconnection services. See *Notice*, para. 81. The dynamic nature of the telecommunications markets would make it very difficult to establish nonarbitrary and stable distinctions among these categories of service. Moreover, in order to provide the most effective protection against unreasonable discrimination, it is essential that the Commission accord uniform regulatory treatment to services that are functionally identical.

consistency test should apply immediately to new services, regardless of whether or not the Commission adopts MFS' previous proposal to incorporate new services directly into the price cap index calculations. Even if a new service were excluded from index calculations, it would still be feasible and appropriate to compare its price-to-cost ratio with the ratios for other services in the trunking basket.

Fourth, the Commission should not adopt the proposal to eliminate pre-effective tariff review until new services are incorporated into price caps.[36] Under the price cap rules, new services may be in effect for as many as 18 months before they are incorporated into the price cap plan.[37] Allowing unreasonable rates—whether discriminatory or unreasonably low or high—to remain in effect for so long a period before subjecting them to Commission review would clearly disserve the public interest. This danger is especially great with respect to "new" services that are actually new pricing options for existing services, since these offerings raise the greatest risk of discrimination between different classes of customers receiving similar services.

This concern is not merely hypothetical. During the first three years of price caps, numerous "new" pricing options proposed by LECs have been rejected as unreasonable by the Commission, or have been withdrawn by the LECs in the face of opposition from interested parties. For example, Ameritech withdrew two attempts to extend term-

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[36] *Notice*, para. 83.

[37] *Policy and Rules Concerning Rates for Dominant Carriers*, 6 FCC Rcd 2637, 2693 (1991).

discounted rates to customers without requiring a corresponding term commitment,[38] and the Commission rejected a Southwestern Bell filing that proposed an indefinite extension of term discounts with no commensurate term commitment;[39] Bell Atlantic withdrew a proposal to waive unspecified charges for customers at will;[40] and NYNEX's proposal to introduce an option to allow customers to include intrastate services in their volume commitments under NYNEX's federal tariff was rejected.[41]

These filings demonstrate that pre-effective tariff review of LEC new service filings has been instrumental in identifying unlawful rates, terms and conditions and in protecting customers and competitors from LEC charges and practices that violate the Communications Act. Delaying such review for up to 18 months after a tariff has taken effect may in practice eliminate the Commission's ability to enforce the Act, because 18 months may exceed the lifespan of many service offerings in emergingly competitive markets. Moreover, allowing a rate to take effect without review could create a virtual presumption of validity, since the Commission is understandably reluctant to upset customer expectations by withdrawing or substantially modifying service offerings after customers have already subscribed to them. In light of the proven value of pre-effective review in identifying unreasonable filings, and of the irreparable harm to competition and

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[38] Ameritech Tariff F.C.C. No. 2, Transmittal Nos. 626 (issued May 18, 1992) and 640 (issued July 15, 1992).

[39] *Southwestern Bell Telephone Companies*, DA 92-1238.

[40] Bell Atlantic, Tariff F.C.C. No. 1, Transmittal No. 438 (issued May 9, 1991).

[41] *NYNEX Telephone Companies*, DA 92-100.

to LEC customers that may result from allowing unreasonable tariff revisions to take effect for up to 1½ years prior to review, the Commission must not adopt the alternative proposal to defer review of LEC new service costs until after the services are incorporated into price caps.

Baseline Issue 8c: Whether new services are available on an equal basis to all LEC customers.

As noted in MFS' response to Baseline Issue 8a, LECs already enjoy excessive pricing flexibility under the existing price cap rules governing new services. This flexibility has allowed them to target new service offerings to the largest access customers, and to narrow geographic areas in which competition has begun to evolve. LECs primarily employ two mechanisms to achieve such targeting. First, LECs employ open-ended volume and term discounted rate structures that provide enormous discounts, but limit them to a small group of the largest access customers in a given market. In fact, by pegging massive discounts to the highest volumes provided under tariff—packages of 12 and 24 DS3 circuits—the LEC offerings effectively become customer-specific offerings that may only be used by a single customer.

Second, LEC tariffs typically contain a caveat that services based on new technology—be it fiber-optic cable or SONET or SS7 central office equipment—are offered only where facilities are available.[42] This caveat essentially allows LECs to

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[42] *See, e.g.*, NYNEX Tariff F.C.C. No. 1, § 11.1 (Special Facilities Routing of Access Services) (stating that "[t]he services provided under this tariff are provided over such routes and facilities as the Telephone Company may elect").

limit new service offerings on a city-specific basis. For example, Bell Atlantic proposed to introduce its Facilities Management Service in only two LATAs within its entire service area—not coincidentally, two LATAs where MFS operated competing networks. Only in response to opposition from MFS and contacts with the Tariff Division Staff did Bell Atlantic revise its offering to make it available throughout its service territory. Similarly, Southwestern Bell's SecureNet and BellSouth's SMARTRing fiber network services initially were introduced only in cities where MFS operates competing networks.

By allowing LECs to target their most highly discounted services to narrow groups of customers in limited geographic locations, the price cap rules permit LECs to limit the deployment of new technologies to customers that face perceived competition, while leaving other customers with services based on less efficient, and more costly technologies. This discrimination in the deployment of efficient new technologies effectively denies the economies of new technology to the majority of the LECs' customers, and forces monopoly ratepayers to bear the entire cost of the LECs' older and less efficient plant.

The discrimination inherent in the LEC's pricing and deployment decisions can best be addressed by adopting the revisions to the price cap rules that MFS has discussed in response to Baseline Issues 2 and 8b. Incorporating new services into price caps immediately upon filing, assigning the services to pricing categories based on their underlying functionalities, and subjecting them to a cost consistency requirement will limit the LECs' ability to target the efficiencies of new technologies to a limited group of customers and to shift the costs of older plant to captive monopoly ratepayers.

Baseline Issue 9b: Whether any other rules or policies that relate to LEC price cap regulation should be revised to equalize our treatment of CAPs and LECs, and if so, what the revised rules and policies should be.

The concept that the Commission should "equalize" the regulatory treatment of CAPs and LECs is valid only to the extent that CAPs and LECs actually are equal in the marketplace. The truth is quite the opposite: as discussed further under Transitional Issues 1a, 1c, and 1d below, LECs have extensive monopoly power as a result of their *de jure* and *de facto* exclusive rights over essential facilities and resources. It is long-standing Commission policy, reaffirmed quite recently, to tailor the level of regulation of particular classes of carriers based upon their possession of market power. The Commission's policy is to classify common carriers as either "dominant," meaning carrier that possess market power, or "non-dominant."[43] It has taken a variety of steps to streamline regulation of the domestic interstate services of non-dominant carriers.[44] However, it has quite recently rejected claims by dominant carriers that their market

[43] *Policy and Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor ("Competitive Carrier Rulemaking")*, First Report and Order, 85 FCC 2d 1, 20-21 (1980).

[44] *Id.*, Second Report and Order, 91 FCC 2d 59, 64 *et seq.* (1982), *recon. denied*, Third Report and Order, 93 FCC 2d 54 (1983), Fourth Report and Order, 95 FCC 2d 554, 577-79 (1983), *recon. denied*, Fifth Report and Order, FCC 84-394, 49 Fed. Reg. 34824, 34829-30 (September 4, 1984); *Tariff Filing Requirements for Nondominant Common Carriers*, 8 FCC Rcd. 6752 (1993), *appeal pending sub nom. Southwestern Bell Tel Co. v. FCC*, Case No. 93-1652 (D.C. Cir. filed Jan. 5, 1994).

power should be ignored so that they could be entitled to the same form of streamlined regulation as non-dominant carriers.[45]

As long as the LECs control essential facilities and resources, and exercise pervasive market power, there is no basis for even contemplating "equalization" of regulation between LECs and CAPs. It is far beyond the realm of possibility that this situation could change during the time frame contemplated for implementation of "baseline" price cap changes; *i.e.*, by January 1, 1995. Whether the situation may change at a later date and then require some changes in regulation of LECs is discussed under the Transitional Issues, below.

Baseline Issue 11: Whether the Commission should adopt revisions to the baseline LEC price cap plan in areas other than those specifically discussed in this Notice.

MFS strongly urges the Commission to adopt Total Service-Long Run Incremental Cost ("TS-LRIC") as the basic cost standard for review of LEC rates, in place of the undefined and unworkable "average variable cost" standard. In the original price cap plan, the Commission adopted average variable cost (AVC) as the price floor for below-band tariff filings, in the belief (based on antitrust literature) that any prices below this level would be presumptively predatory, although prices above AVC might still be proven predatory in specific cases.[46] In addition, the Commission appears to have

[45] *Southwestern Bell Tel. Co., Revisions to Tariff F.C.C. No. 73*, Transmittal No. 2297, DA 94-204 (released March 4, 1994); *Southwestern Bell Tel. Co., Revisions to Tariff F.C.C. No. 73*, Transmittal No. 2316, DA 94-354 (released April 15, 1994).

[46] *LEC Price Cap Order*, 5 FCC Rcd. at 6824, paras. 305-310.

adopted AVC *de facto* as its standard for analyzing claims that existing rate levels are unjust or unreasonable.[47]

Economic analyses performed subsequent to the adoption of price caps have shown that AVC is not the best standard for identifying predatory pricing given the particular characteristics of the telecommunications industry, and that TS-LRIC would be a more suitable standard. TS-LRIC is the difference in a firm's total costs with and without that particular service, divided by the output of that service.[48] In contrast to the average variable cost standard, which looks at an increase in a firm's total costs as a result of a small increase in the output of the service, the entire quantity of the service is examined under TS-LRIC methodology.[49] Also in contrast to the average variable cost "snapshot," TS-LRIC more realistically examines costs over a longer time frame, encompassing replacement of all existing equipment.[50]

Regulated telephone companies have every incentive—and are capable of—selling services in competitive markets at prices that may be below cost.[51] In addition,

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[47] *See* letters from Cheryl A. Tritt, Chief, Common Carrier Bureau to John C. Litchfield of Ameritech, Michael R. McCullough of Bell Atlantic, A.E. Swan of Pacific Bell, and Glenn H. Brown of U S West (all dated December 18, 1992).

[48] *See* Comments of MCI Telecommunications Corporation, *Transport Rate Structure and Pricing*, CC Docket No. 91-213 (Feb. 1, 1993) ("*MCI Transport Comments*") at 25; Hatfield Associates, Inc. & Economics and Technology, Inc., *The Enduring Local Bottleneck: Monopoly Power and the Local Exchange Carriers* (1994) ("*Enduring Local Bottleneck*") at n.178.

[49] *MCI Transport Comments*, Attachment A at 1.

[50] *Id.* at 1-2.

[51] *See Enduring Local Bottleneck* at 188.

> to the extent that resources acquired in the course of providing core monopoly services can be utilized by a BOC to furnish the competitive service at less than the price that such assets would command if purchased on a stand-alone basis, the integrated [monopoly] firm will have a decided edge over any competitors.[52]

The temptation to cross-subsidize is made even more appealing when such cost transfers can be easily hidden. Because AVC studies use an extremely short term perspective, they systematically understate the costs of competitive services for LECs by leaving out of the analysis the investment required for competitive services.[53] LECs under the current AVC standard in the price cap rules are therefore able to recover those investment costs from the monopoly ratepayer, and charge predatory rates for competitive services. As MCI and others have demonstrated, TS-LRIC protects against such LEC tactics as cross-subsidization and predatory pricing by requiring that LEC prices recover the *full* cost of providing a service.[54]

Moreover, the local telephone business is an inappropriate industry to which to apply average variable costing. Local telephone service

> is characterized by extremely high fixed costs and low (or in some cases near-zero) variable costs . . . . A short run marginal cost test is not particularly useful or applicable for industries characterized by low product-specific variable costs. In the case of local telephone service, most costs are in fact fixed over a broad range of output and mix of services, because the same fixed common stock of capital is used to produce a

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[52] *Enduring Local Bottleneck* at 188.

[53] D. Kelley and R. Mercer, *A General Approach to Local Exchange Carrier Pricing and Interconnection Issues* (September 19, 1992 Working Paper) ("*LEC Pricing*") at 21.

[54] *Id.* at 2.

> spectrum of services ranging from highly monopolistic to highly competitive.[55]

In addition, AVC is not appropriate

> [i]f a particular function [service] exhibits marked economies of scale, [because] the incremental cost of a small change in demand may be very small if the starting demand level is relatively high. Prices set to recover only this small increment will fail to account for the fact that average incremental costs over the entire range of demand will be higher than marginal cost, and thus will fail to recover all of the costs of producing the function.[56]

It is no surprise, then, that the LECs support use of average variable cost standards to facilitate cross-subsidization and predatory pricing. At the same time, it should be no surprise to the Commission that continued use of average variable cost standards will help block effective competition in local telecommunications services.

Moreover, the application of the AVC test to LEC services during the first three years of price cap regulation has failed to establish coherent standards. Indeed, in every case in which the adequacy of LEC AVC showings have been contested by interested parties, the Commission has allowed the rates at issue to take effect, and has never substantively responded to the arguments raised against them.[57] In the absence of

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[55] *Enduring Local Bottleneck* at 188.

[56] Comments of MCI, *NARUC's Request for a Notice of Inquiry Concerning Access Issues*, DA 93-847 (September 2, 1993) at 20.

[57] In the case of every contested LEC AVC filing, the Commission has either dismissed arguments contra with a form order that does not discuss substantive issues, *GTE Telephone Operating Companies*, 7 FCC Rcd. 7181 (1992), or has not concluded proceedings that were designed to address the substantive arguments, *1992 Annual Access Filings*, 7 FCC Rcd. 4731 (1992). The Commission has accorded similar treatment to arguments against to AT&T AVC showings. The FCC rejected AT&T's first below-band filing on the grounds that the carrier's (continued...)

substantive discussion of the AVC test, virtually no standards have been established under the LEC price cap regulatory regime.

For these reasons, the Commission should adopt TS-LRIC as its basic cost standard for review of LEC rates. This standard should be applied to determine whether below-band filings should be presumed predatory; to determine the initial level of "direct" costs attributable to a new service; and to apply the cost consistency test described under Baseline Issue 2, above.

Transition Issue 1a: What is the current state of competition for local exchange and interstate access?

In the "Transitional Issues" section of the *Notice*, the Commission has requested comments on whether and how it should revise the baseline price cap plan over time as competition develops in LEC markets. Although MFS recognizes that it is prudent to begin planning for a transition to competition, any analysis of these issues must begin by recognizing that LECs remain dominant in their markets today and will continue to be so for the foreseeable future. Although LECs face more competition today than they did ten years ago, or indeed than they have at any time over the past 75 years, *any* increase in competition, no matter how slight, would appear dramatic compared to the absolute and pervasive monopolies these companies used to enjoy. In fact, the emergence of competition within some specialized niche markets for a limited range of services, within

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[57](...continued)
proffered incremental net revenue data did not constitute the AVC showing required by the price cap rules. Other than that finding, the FCC has never elaborated on the adequacy of an AT&T AVC showing. *See Price Cap Performance Review for AT&T*, 7 FCC Rcd. 5322, 5324 (1992).

a relative handful of geographic markets, has had an imperceptible impact on LEC revenues and profits, and has not changed the underlying market dynamics that cement the LECs' market power.[58]

The supposed "competitive threat" facing the LECs is imaginary today given the LECs' continuing market dominance and the existence of substantial legal and practical barriers to effective competition. The Commission should bear in mind that interstate access service is not provided in a vacuum or on a stand-alone basis. Rather, interstate access is merely one use of the LECs' ubiquitous and integrated telecommunications facilities. LEC central offices, tandems, interoffice transport networks, and large parts of the local loop plant are used in common to provide a range of services including basic local exchange service, "vertical" service features, intraLATA toll calling, interLATA switched access, switched data services, local private lines, and interstate special access. The costs of these shared and common facilities are not attributable to any single service, but must be recovered through the rates charged for all of these various services.

Given the pervasive use of common facilities within LEC networks, the only meaningful way to analyze "the current state of competition" is with respect to *all* services offered in a geographic area large enough to encompass the major part of shared

[58] *See e.g.*, Comments of Competitive Telecommunications Association, *In the Matter of NYNEX Transition Plan to Preserve Universal Service in a Competitive Environment*, DA 93-1537 (January 31, 1994); Comments of LOCATE, Inc., *In the Matter of the NYNEX Telephone Companies Petition for Waiver for Transition Plan to Preserve Universal Service in a Competitive Environment*, DA 93-1537 (January 31, 1994).

and common facilities.[59] Emerging competition that exists only for a limited subset of the services offered by the LEC, or only within a small fraction of the geographic area served by the relevant LEC facilities, cannot significantly affect the LEC's market power because the LEC can simply shift the recovery of shared and common costs to other services or geographic niches. Indeed, allowing LEC pricing flexibility under conditions of "incomplete" competition may actually make many consumers worse off than they would be under a pure, regulated monopoly, because the LEC would then be able to recover a larger share of shared and common costs on a selective basis from those consumers who do not have competitive options available to them. If all services were subject to competition throughout the relevant geographic area, however, this could not occur because the amount of shared and common costs that could be recovered from any particular customer group would be limited by market forces.

Viewing the market as a whole, the LECs not only have a market share of virtually 100 percent,[60] but also enjoy legal and structural advantages (as discussed

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[59] For example, many of the LECs' fixed plant investments (such as central office buildings, loop facilities, and switches) can be identified with services provided to customers in specific central office districts, although not to specific services. Tandem switches and interoffice facilities serve larger geographic areas, sometimes incorporating an entire LATA or study area, while such "back-office" facilities as billing systems and general-purpose computers, and the personnel who operate them, may serve one or more study areas depending upon the LEC. Other shared costs, such as maintenance facilities and the personnel, equipment, and vehicles associated with them, may be associated with geographic territories of intermediate size (more than one central office district but less than an entire LATA or study area).

[60] The estimated annual telecommunications services revenues of the Tier I LECs are over $85 billion, while the annual revenues of the entire competitive access provider (CAP) industry in 1992 were less than $250 million, of which approximately $175 million were derived from telecommunications services. Connecticut Research, Inc., *1993 Local Telecom-*
(continued...)

further under Transitional Issues 1b and 1c) which directly protect much of their revenues against competition *and* indirectly give them significant cost and marketing advantages for those services that do face competition. Therefore, it would be premature to contemplate any substantial increase in LEC pricing flexibility as a so-called "competitive response," either now or in the short term.

Transition Issue 1b: What criteria if any should be used for determining when reduced or streamlined regulation for price cap LECs should take effect?

Paragraph 95 of the *Notice* correctly implies that there is no single, simple criterion for determining when "enough" competition exists in a particular market to eliminate a particular LEC's ability to exercise market power. A number of factors must be considered, giving particular emphasis to the legal, technical, and practical "bottlenecks" that are the foundations of the LECs' market power today.[61]

The LEC "bottlenecks" take a variety of forms. MFS uses this term to refer to any means by which a LEC can impede competitors, either as a legal or practical matter, from providing all forms of telecommunications services to all customers (either by excluding them from the market entirely or by placing them at a cost or quality

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[60](...continued)
munications Competition ... the "ALT Report" (Aug. 1993). Thus, the CAP industry's share of the local telecommunications market is approximately 0.2 percent. Confirming this market estimate, AT&T has stated publicly that, in 1992, only $19 million out of its $14 *billion* in access expense, or 0.14 percent, was paid to non-LECs. Letter from Thomas H. Norris, AT&T, to Sen. Daniel K. Inouye, August 2, 1993. Similarly, MCI has stated that 99.4 of the access charges it paid in 1992 were received by LECs, and only 0.6 percent by their competitors. Letter from Gerald J. Kovach, MCI, to Sen. Inouye, September 17, 1993.

[61] *See Enduring Local Bottleneck passim.*

disadvantage in the market). Although purely legal barriers to market entry have been eliminated for interstate services, they remain formidable obstacles to competition in intrastate services (which account for the majority of LEC revenues[62]) in nearly all jurisdictions. LECs enjoy exclusive franchises to provide local telecommunications services in many states;[63] enormously favorable and discriminatory municipal franchise agreements and tax treatment; and preferred access to public rights-of-way in many jurisdictions. In addition, the LECs' historical monopoly has enabled them to obtain highly favorable terms for access to privately-owned property including access to multi-tenant buildings, as well as favorable pole attachment and conduit agreements with third parties.

In addition, interconnection to the LEC network is a critical bottleneck from an operational standpoint, especially for basic local exchange services. Without interconnection, there would be no point in considering local exchange competition. No one would use a telephone service offered by a competitive entrant if it did not offer the ability to

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[62] In 1992, basic local exchange revenues accounted for $39.9 billion, or nearly half of the Tier I LECs' total revenues of $87 billion; state access revenues accounted for an additional $6.6 billion; and toll revenues, a large portion of which are likely attributable to intrastate, intraLATA services, provided $12.9 billion. Interstate access charge revenues were $19.8 billion, or less than one-quarter of total revenues. *Statistics of Common Carriers*, 1992/1993 edition, Table 2.9 at 39-40.

[63] Quite a few states (*e.g.*, Florida, North Carolina) have adopted statutes expressly prohibiting their regulatory commissions from authorizing competition in local exchange services; a larger number of states have simply maintained exclusivity as a matter of practice or precedent. To date, only three states (New York, Washington, and Maryland) have actually certificated a competitive facilities-based provider of local exchange service, although statutes or regulatory policies in a few other states (Illinois, Michigan, Massachusetts) would permit such certification if the state regulator finds it to be in the public interest.

make calls to, and receive calls from, the incumbent LEC's existing ubiquitous customer base (as well as the rest of the public switched telephone network). Indeed, even if a new entrant were to build facilities that were capable of reaching every customer in a given service territory, the new entrant would still require interconnection with the incumbent as long as the latter remains in the market.[64] Although interconnection must be a two-way street, since the incumbent's customers have just as great a need for ubiquitous calling as do the new entrant's, the financial impact of interconnection terms falls much more heavily on new entrants than on incumbents because the incumbent enters the competition with an initial 100 percent market share. During the transition to competition, the incumbent will be able to complete most local calls using only its own network, since most of the customers will remain on that network, while the new entrant will require interconnection for completion of the great majority of all originating and terminating calls.[65]

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[64] In a recent Maryland proceeding concerning local exchange competition, Bell Atlantic's expert witnesses acknowledged that interconnection is an "essential input" to competitors, and that the state commission should regulate the terms of interconnection to prevent both inefficient pricing and "discrimination in the price or the quality or other terms or conditions of interconnection." Maryland P.S.C. Case 8584, *MFS Intelenet of Maryland, Inc.*, Direct Testimony of Alfred Kahn and William Taylor at 11-12.

[65] For example, if at some time in the future the incumbent's market share declines to 90% and the new entrant captures a market share of 10%, and assuming that customers place and receive calls to and from each other in a randomly distributed manner, then 81% of all traffic within this market would be completed entirely on the incumbent's network (90% of the calls made by 90% of the customers); only 1% (10% of the calls made by 10% of the customers) would be completed entirely on the new entrant's market; and the remaining 18% would traverse both networks. The costs of interconnection therefore would have a *proportionately* much greater impact on the new entrant than on the incumbent.